No. 12588

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

MARGARET BRYAN SMITH,

Appellant,

vs.

HARRY C. WESTOVER, UNITED STATES COLLECTOR OF INTERNAL REVENUE, SIXTH COLLECTION DISTRICT OF CALIFORNIA,

Appellee.

REPLY BRIEF FOR APPELLANT.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Miscellaneous

Statutes

Textbooks

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Summary of Argument.

State law is controlling in establishing the incidents and characteristics of a trust and the Federal taxing authorities are governed by State construction of state provisions. Whether or not the Congress could constitutionally provide for a complete disregard of State Law concerning trusts, contracts and Wills, the Statute (I. R. C. Sec. 162 (d)(1)) has not done so here. Concededly the taxpayer is not the recipient of income here, but the tax assessed against the taxpayer is on the income received by the trust measured by the corpus distributed to the taxpayer. This is merely taxing one taxpayer on income received by an-

other without any of the considerations that underlay cases like *Helvering v. Clifford,* 309 U. S. 331, or *Helvering v. Stuart,* 317 U. S. 154.

The Sixteenth amendment to the Constitution applied only to income tax, and did not itself authorize any taxation of gifts of principal such gifts. They may be taxable as gifts under the provisions of estate and gift tax law not constitutionally within the purview of the Sixteenth Amendment's authority, but they cannot be so taxed *as income.*

ARGUMENT.

I.

For Purposes of State Law Income as Received by the Trust Became Corpus and There Was Never Any Income Currently Distributable.

Appellee concedes that under California law the trust is valid and that income as received becomes corpus as it is received by the trust and so there is never any income available for distribution. He however takes the position that the California law is irrelevant and that constitutionally and under the Internal Revenue Code distributions of a fixed share of the corpus can be taxed as if they were income receipts. (Br. pp. 11-12.) The question here reduces itself then to the propositions whether I. R. C. Sec. 162(d)(1) authorizes the taxation of periodic payments setting aside portions of corpus to appellant, and whether, if the statute is given such meaning and application, it can be so applied constitutionally.

II.

Appellant Is Under the State and Federal Law the Recipient of Corpus and Is Not Taxable on Her Receipt.

In answering the contentions of appellee to the effect that the Statute (I. R. C. Sec. 162(d)(1)) with which we are dealing, or at least the statute plus the Treasury Regulations (Treasury Regulations 111, Sec. 29.162-2) impel a determination that the payments Appellant received are taxable as income, it is respectfully submitted that there is nothing so compelling therein. Apposite may be a statement by Lloyd W. Kennedy in his text on Taxation of Trusts and Estates. He says (Kennedy, Federal Income Taxation of Trusts and Estates (1948), Sec. 2.12, p. 160),

> "Sec. 162(d)(1) consists of four sentences, the first three of which are about as distressing to the understanding as any three sentences ever sponsored by a presumably august body as the Congress of the United States."

The question here is not what Congress hoped to do, or what Appellee wishes they had done, but what they actually did. Mertens in commenting on this section bears out this contention, stating that Congress did not choose to disregard state law or the language of trust instruments. The author states as follows (Mertens, Law of Federal Income Taxation, Vol. 6, Sec. 36.41a, p. 320):

> As to what, generally, constitutes "income" as contrasted with corpus, the regulations come up with a bastardization leaving much to be desired, the statute itself being no clearer in the matter. It does not expressly disregard quirks and variances in state law or absurdities in trust instruments as to what shall constitute "income" and what "corpus." It does not

say, in dealing with distributions out of "other than income," what the "other than" is that Congress had in mind. By sins of both commission and omission it leaves a considerable range of controversy which the regulations only attempt to deal with as follows: They say that "income" as used in the broader sense must be determined in accordance with the following principles:

> "First, such 'income' means, in general, the amount which under the applicable law of estates and trusts is considered income available for distribution to the life tenant, legatee, or beneficiary, as the case may be."

We do not here have a "Clifford doctrine" situation (*Helvering v. Clifford,* 309 U. S. 331), where exceptional and unusual facts establishing control in the grantor and the possibility of avoidance of income taxation led to a result in which judicial legislation played a considerable part. And even within the field of the *Clifford* case, 309 U. S. 331, *supra,* it has been often limited and distinguished and the importance of state law concerning the meaning and validity of trusts is recognized. (See *Robert P. Scherer,* 3 T. C. 776.) Such a case is *May Chandler Gooden,* 12 T. C. 817 (1949), where the court followed *Lady Marian Bateman,* 43 B. T. A. 69 (aff'd 127 F. 2d 266 *sub. nom. Commissioner v. Bateman*) and relied on *Bixby v. California Trust Co.,* 84 A. C. A. 297, 190 P. 2d 321 (1948), as it then stated the law of California, in determining revocability of the trust and the powers of the beneficiaries to control the trust. The court distinguished *Helvering v. Clifford,* 309 U. S. 331, *supra,* and *Stanley J. Klien,* 4 T. C. 1195.

Thus we see that state law is not to be lightly disregarded. Too much is sometimes assumed concerning the unimportance of state law regarding trusts and *Helvering v. Clifford,* 309 U. S. 331, *supra,* and kindred cases are sometimes cited as if they had removed all relevance of state law from this field of income taxation. Mertens (*op. cit.* p. 504) notes that many trusts have weathered the storm of the *Clifford* doctrine and cites numerous cases. Thus, it is seen that the *Clifford* case and other cases cited by Appellee (Br. p. 14) merely recognize the doctrine as set out in the quotation from *United States v. Phellis,* 257 U. S. 156, 168, to the effect that substance and not form is important in deciding income tax questions. The case of *Anderson v. Wilson,* 289 U. S. 20, 27, cited by Appellant in her opening brief (Br. p. 21) deals with the two questions that are basic to the questions here. It (pp. 24-26) considers the application of state law to the facts and then proceeds, after determining the nature, the interest, and title of the trustees, to apply the Federal income tax law in the light of the interpretation given by state law. A trust is an entity set up and governed by state law, and though an "abstraction" the court treats it separately for tax purposes in accordance with law.

In general state law must be looked to for definitions of trust income and corpus and for the validity and interpretation of trust provisions. After determining these matters in accordance with state law, then the Internal Revenue Code provisions, with the help of the Treasury Regulations are applied thereto. In discussing this matter and the effect of Internal Revenue Code 162(d)(1) Mertens says (*op. cit.*, Sec. 36.41a, pp. 315-16):

> "The beneficiary's rights in an estate or trust are by no means measured in terms of taxable income.

They depend upon local law and the terms of the governing instrument. Though he is an income beneficiary or annuitant, that does not mean that he is enentitled to a certain amount or share of taxable income, but only that he is entitled to share in income as contrasted with corpus, and the extent of his rights may be affected by local law, discretion of the fiduciary or the court before which the administration is pending, or the terms of the particular will or trust in its treatment of what shall constitute income or corpus and how charges and expenses shall be allocated as between them. Generally speaking, no one can be taxed with respect to income which is not his or over which he does not have control tantamount to ownership."

It has been argued that I. R. C. Sec. 162(d)(1) (at least as applied by the Commissioner) has set up a conclusive presumption. This, basically is what the sought for interpretation of the section means. As is stated in Mertens, Law of Federal Income Taxation, Vol. 6, Sec. 36.41a, p. 317:

> "In an attempt to clarify the situation a 1942 Amendment of the Statute sets up what appears to be at first glance an attempt to create a conclusive presumption that a distribution is out of 'income' to the extent that it could be out of 'income' . . ."

The cases of *Heiner v. Donnan,* 285 U. S. 312, and *Schlesinger v. Wisconsin,* 270 U. S. 230, deal with conclusive presumptions that a gift given within a fixed period

of years preceding death was given in contemplation of death. The Court said in *Heiner v. Donnan,* 285 U. S. 312, 325, in discussing the *Schlesinger* case,

> "The Schlesinger Case has since been applied many times by the lower federal courts, by the Board of Tax Appeals, and state courts; and none of them seem to have been at any loss to understand the basis of the decision, namely, that a statute which imposes a tax upon an assumption of fact which the taxpayer is forbidden to controvert, is so arbitrary and unreasonable that it cannot stand under the 14th Amendment."

The court then states that the fact that it is the Fifth Amendment that is involved makes no difference. The Court then quotes with approval from *Hoeper v. Tax Commission,* 284 U. S. 206 (a state tax case) as follows (p. 326):

> "At page 215 we said: 'We have no doubt that. because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the 14th Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income.' "

The *Hoeper* case involved a statute of Wisconsin that provided that the income of the wife should be added to that of the husband in computing the income tax assessable to and payable by the husband. The analogy to the instant

case is clear. To tax a part of the income of a trust to a beneficiary because the trust acted as a conduit in delivering the income to the beneficiary is one thing; it is quite another to proportion a corpus distribution to income received by a trust and tax the beneficiary on the trust income measured by corpus distribution.

One fact that must not be lost sight of here is the fact that no income is kept on tap, or in "cold storage" as it were, and later handed over to the beneficiary. Here income has lost its character as such and only corpus is on hand to be distributed.

We thus see that the cases set forth above establish the proposition that taxation of one person on income of another violates due process of law and that taxation of items not received as income is not authorized by the Sixteenth Amendment.

The development of the law as typified by *Helvering v. Clifford,* 309 U. S. 331; *Commissioner v. Court Holding Co.,* 324 U. S. 331; *Helvering v. Stuart,* 317 U. S. 154, and *Corliss v. Bowers,* 281 U. S. 376, does not disturb this basic proposition that the taxation of one person on income of another is unconstitutional. These cases, and many more dealing with similar special fact situations are all based, in the end, on the proposition that the person sought to be taxed is the substantial owner of the income in a practical sense. The *Clifford* cases base this finding of ownership on the substantial elements of control retained by a grantor of an *inter vivos* trust, and the shortness of the trust term. This is of course a question of fact in

each case. The *Tower* case, 327 U. S. 280, *supra,* is a family partnership case and depends on the elements of control by the head of the family and the substantiality of the interests of the wife as partner and the reality of her services to the partnership.

The case of *Corliss v. Bowers,* 281 U. S. 376, is another donor case where control of trust property was retained. Again, the principle was applied to a different type of factual situation in *Commissioner v. Court Holding Co.,* 324 U. S. 331, where a corporation was taxed as having made the sale of its sole asset despite the fact that in form the sale was made by the two stockholders (who were husband and wife).

The case of *Burchenal v. Commissioner,* 150 F. 2d 482 (C. C. A. 6, 1945), held that the mere fact that the Revenue Law treats capital net gain as taxable income, does not prevent this gain from becoming part of the corpus of the estate upon its realization, citing *Helvering v. Butterworth,* 290 U. S. 365, and *Burnett v. Whitehouse,* 283 U. S. 148. The Court said that such gain was actually part of the corpus and could not be properly credited as income. The Court relied on the law of the State of Ohio which held such gain to be corpus. The case of *Carlisle v. Commissioner,* 165 F. 2d 645 (C. C. A. 6, 1948), did not change this rule, it merely held that if this same gain was within the year distributed to the trust beneficiary, then it could be treated as income in his hands. If this gain had not been distributed, a contrary result would follow, as in the instant case where the income was not distributed.

III.

Legislative History Does Not Impel a Finding That the Congressional Purpose Was to Tax the Beneficiary in the Instant Situation.

Appellee cites the House and Senate Committee reports, to demonstrate how I. R. C. Sec. 162(d)(1) should be interpreted, and to support the language in Treasury Regulations 111, Sec. 29.162-2. The House Report said (H. Rep. No. 2333, 77th Cong., 2d Sess., p. 1 (1942-2 Cum. Bull 372, 408), "Where the amounts to be distributed are a charge upon the corpus as well as income, to the extent the payments are made from income they will be taxable to the beneficiary and will constitute a deduction to the trust."

The Senate Report is cited by Appellee as authority for his position. However, the Court's attention is respectfully called to some additional language in the report at page 560 (S. Rep. No. 1631, 77th Cong., 2d Sess., p. 72 (1942—2 Cum. Bull. 504, 560)):

> "The aggregate of such amounts is considered to be paid, credited, or distributed in such cases out of income of the estate or trust for its taxable year if it does not exceed *the distributable income* of the estate or trust for its taxable year." (Italics supplied.)

Also the term income is defined further along on page 560, as follows:

> ". . . 'income' means, in general, *the amount which under the applicable law of estates and trusts* is considered income available for distribution to the life tenant, legatee, or beneficiary, as the case may be."

If no distributable income was available the payments to appellant cannot be considered as "out of income." The

quotation last above from the Senate Report is a clear direction to the taxing authority to look to the applicable state law for a determination as to whether a particular fund constitutes income or corpus.

Conclusion.

Finally it is respectfully submitted and reiterated on behalf of the Appellant:

I.

That (I. R. C. Sec. 162(d)(1)) does not apply to Appellant and if so applied such application is unconstitutional.

II.

That by established Federal law, including both statutory and case law, the Commissioner is bound to recognize the law of California concerning wills, trusts and contracts, and having made such recognition is bound to hold that there is no income available for distribution to her, and that therefore, no tax should be laid on distribution of the corpus to the Appellant.

III.

That legislative history does not impel a contrary conclusion.

The decision of the Court above is erroneous and should be reversed.

Respectfully submitted,

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Counsel for the Appellant.